



*Improvements Are Needed in Resource
Allocation and Management Controls for
Audits of High-Income Taxpayers*

September 18, 2015

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HIGHLIGHTS

IMPROVEMENTS ARE NEEDED IN RESOURCE ALLOCATION AND MANAGEMENT CONTROLS FOR AUDITS OF HIGH-INCOME TAXPAYERS

Highlights

Final Report issued on September 18, 2015

Highlights of Reference Number: 2015-30-078 to the Internal Revenue Service Commissioners for the Large Business and International and the Small Business/Self-Employed Divisions.

IMPACT ON TAXPAYERS

High-income taxpayers are frequently involved in complex entities and financial arrangements that provide greater opportunities for aggressive tax planning. It is important for the IRS to demonstrate that it enforces tax laws equally by ensuring that its compliance strategies are applied fairly to all segments of the taxpayer population.

WHY TIGTA DID THE AUDIT

High-income taxpayers can present a unique challenge to tax administration due to the complexity of their financial affairs. This audit was initiated to evaluate the IRS's efforts to ensure the tax compliance of high-income taxpayers.

WHAT TIGTA FOUND

The IRS has taken steps to improve its audit coverage of high-income taxpayers. The IRS adopted a High-Income and High-Wealth strategy focused on auditing more tax returns related to high-income individuals. As a result, audit coverage of high-income taxpayers has improved. However, the IRS should reevaluate whether the threshold for its High-Income and High-Wealth strategy, set at \$200,000, results in an efficient allocation of examination resources.

Additionally, as part of this strategy, the Large Business and International (LB&I) Division established the Global High Wealth (GHW) Industry to specifically address tax compliance issues of high-income taxpayers. The GHW

Industry takes a comprehensive approach in auditing high-income taxpayers by extending the audits beyond the individual income tax return to include examining the entities that these taxpayers control.

However, LB&I Division management has not yet established the GHW Industry as a standalone industry capable of conducting all of its own examinations. Currently, management is using resources from three other LB&I Division industries to assist with auditing GHW Industry enterprise cases without having evaluated the impact of that decision on those other industries.

TIGTA also found that the complexity of the financial affairs of many high-income taxpayers and the limitations of the IRS's audit information systems prevent the IRS from systemically quantifying GHW Industry audit performance. Further, the LB&I Division has not taken a number of steps to ensure that the GHW Industry evolves into a mature industry. For example, the GHW Industry has not implemented a quality review process for its audits.

WHAT TIGTA RECOMMENDED

TIGTA recommended that the IRS:

- 1) reevaluate the income thresholds in its High-Income and High-Wealth strategy;
- 2) conduct a cost/benefit analysis of the GHW Industry's outsourcing initiative;
- 3) explore system modifications needed to systemically quantify GHW Industry enterprise case examination results;
- 4) ensure that its management reports accurately reflect that there currently is no audit quality measure for the GHW Industry;
- 5) establish a permanent ongoing quality review system; and
- 6) require quality reviews of closed GHW Industry examination cases.

The IRS agreed with four of the six recommendations. However, the IRS does not agree that its decision to outsource GHW Industry enterprise cases requires a cost/benefit analysis and is not planning to explore system modifications needed to better quantify enterprise case examination results. TIGTA believes that both the cost/benefit analysis and better information on examination results would improve program decisions.



TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

September 18, 2015

MEMORANDUM FOR COMMISSIONER, LARGE BUSINESS AND INTERNATIONAL
DIVISION
COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED
DIVISION

FROM: Michael E. McKenney
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Improvements Are Needed in Resource
Allocation and Management Controls for Audits of High-Income
Taxpayers (Audit # 201430023)

This report presents the results of our review to evaluate the Internal Revenue Service's efforts to ensure the tax compliance of high-income taxpayers. This review is included in our Fiscal Year 2015 Annual Audit Plan and addresses the major management challenge of Tax Compliance Initiatives.

Management's complete response to the draft report is included as Appendix VI.

Copies of this report are also being sent to the Internal Revenue Service managers affected by the report recommendations. If you have any questions, please contact me or Matthew A. Weir, Assistant Inspector General for Audit (Compliance and Enforcement Operations).



*Improvements Are Needed in Resource Allocation and
Management Controls for Audits of High-Income Taxpayers*

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Abbreviations

GHW	Global High Wealth
IRS	Internal Revenue Service
LB&I	Large Business and International
QSP	Quality and Special Projects
SB/SE	Small Business/Self-Employed
TEFRA	Tax Equity and Fiscal Responsibility Act
TIGTA	Treasury Inspector General for Tax Administration
TPI	Total Positive Income



Improvements Are Needed in Resource Allocation and Management Controls for Audits of High-Income Taxpayers

Background

High-income taxpayers pay a large portion of the total income tax collected each year.¹ However, these taxpayers also present a unique challenge to tax administration due to the complexity of their financial affairs. High-income taxpayers are frequently involved in complex entities and financial arrangements, including trusts, real estate investments, foundations, privately held companies, partnerships, and international activities, all of which can increase the risk of noncompliance with the tax laws.

As the primary agency responsible for collecting the Government's tax revenue, it is important for the Internal Revenue Service (IRS) to demonstrate that it enforces tax laws equally by ensuring that its compliance strategies are applied fairly to all segments of the taxpayer population. In October 2009, the IRS Commissioner stated that the IRS created a High-Income and High-Wealth strategy to address noncompliance of high-income taxpayers. This included the establishment of the High-Income and High-Wealth Strategy Council (hereafter referred to as the Strategy Council) in January 2010 to oversee the implementation of its overall High-Income and High-Wealth strategy. To ensure a well-coordinated approach, Strategy Council members include executives from all IRS business operating divisions. The Strategy Council's mission is to design, develop, and implement a Service-wide approach to:

- Maximize high-income taxpayer audit coverage.
- Select the best possible workload to ensure coverage and collectability while also considering taxpayer burden issues.
- Oversee the high-income audit workload selection and delivery among the business operating divisions and determining which is best suited to address a high-income taxpayer's unique characteristics.

The IRS identifies high-income taxpayers as those who reported total positive income (TPI) of at least \$200,000 on Form 1040, *U.S. Individual Income Tax Return*.² To ensure a comprehensive coverage of the high-income taxpayer population, the Strategy Council stratified the population into six tiers (based generally on the individual's TPI) and assigned primary responsibility for each tier to a business operating division. The Large Business and International (LB&I) Division assumed responsibility for two tiers, covering high-income taxpayers with TPIs of at least \$5 million, while the Small Business/Self-Employed (SB/SE) Division took on the remaining four tiers, covering all high-income taxpayers with TPIs greater than \$199,999 but

¹ In the United States, the top 1 percent of all income-earning individuals pays approximately 40 percent of the total Federal individual income taxes paid.

² See Appendix V for a glossary of terms.



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less than \$5 million. In addition, the SB/SE Division is responsible for addressing the compliance of high-income individual nonfilers and partnership investors falling under the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA).³

In Fiscal Year 2010, the LB&I Division established the Global High Wealth (GHW) Industry to meet its High-Income and High-Wealth strategy responsibilities. It was initially started as a Compliance Initiative Project. The GHW Industry takes a more comprehensive approach to address the high-income taxpayer population by looking beyond a taxpayer’s individual income tax return to include the taxpayer’s complete financial picture, including all entities they control (hereafter referred to as an “enterprise case”). A GHW Industry enterprise case consists of a key case, generally the taxpayer’s Form 1040, and related income tax returns for which the taxpayer has a controlling interest in the entity and a significant compliance risk may exist. These entities may include partnerships, trusts, S corporations, C corporations, private foundations, *etc.* The enterprise case would also include other individual income tax returns affected by flow-through adjustments made on the tax returns for partnerships and S corporations controlled by the key taxpayer.

According to the GHW Blueprint, LB&I Division management planned to fully staff the GHW Industry with 242 examiners (*e.g.*, revenue agents) and 58 management/support staff by the end of Fiscal Year 2011.⁴ However, due to resource limitations, the GHW Industry had only 96 examiners and 24 management/support staff as of the end of Fiscal Year 2014, which is 40 percent of what LB&I Division management had originally planned. Figure 1 compares the staffing of the various LB&I Division industries as of the end of Fiscal Year 2014.

Figure 1: Comparison of LB&I Division Staffing by Industry as of the End of Fiscal Year 2014⁵

Industry	Total Staffing	Examination Staffing
Communications, Technology, and Media	532	458
Financial Services	544	467
Global High Wealth	120	96
Heavy Manufacturing and Pharmaceutical	686	590
Natural Resources and Construction	836	447
Retailers, Food, Transportation, and Healthcare	843	735

Source: LB&I Division and GHW Industry management.

³ Pub. L. No. 97-248, 96 Stat. 324 (codified as amended in scattered sections of 26 U.S.C.). For more information on the complete provisions of the TEFRA, see the Joint Committee on Taxation, JCS-38-82, *General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982* (Dec. 31, 1982).

⁴ This document outlined the proposed organizational structure and staffing for the GHW Industry.

⁵ The data in this table represent the number of employees on staff.



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This review was performed at the GHW Industry office in Ogden, Utah, and with information obtained from the LB&I Division Headquarters in Washington, D.C., and the SB/SE Division Headquarters in Lanham, Maryland, during the period March 2014 through June 2015. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.



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Results of Review

The IRS has taken steps to implement its High-Income and High-Wealth strategy and affirm its commitment to review tax returns of high-income taxpayers and their related businesses and entities. As a result, audit coverage of high-income taxpayers has improved. However, the IRS should reevaluate the income level it uses to identify taxpayers for its High-Income and High-Wealth strategy so that it can better allocate audit resources to the most significant audit risks.

In addition, LB&I Division management has not determined how to best manage and incorporate the GHW Industry into its overall compliance strategy. Specifically, management is using resources from three other LB&I Division industries to assist with auditing GHW Industry enterprise cases without having evaluated the impact of that decision on those other industries. Moreover, the IRS has not taken steps to stand up the GHW Industry as a fully self-sustaining industry comparable to the other five LB&I Division industries. For example, the GHW Industry lacks a quality review process for its examination work as well as a systemic method to quantify the outcome of each enterprise case examination.

The Internal Revenue Service Has Improved Its Audit Coverage of High-Income Taxpayers

Since the Strategy Council and GHW Industry were established, the IRS has increased its audit coverage of high-income taxpayers. As shown in Figure 2, the percentage of high-income taxpayers audited increased from Fiscal Year 2010 to Fiscal Year 2013, with higher percentage increases in the highest three income levels. However, the audit coverage dropped in most income levels in Fiscal Year 2014.

IRS management informed us that declining budget allocations resulted in fewer audits closed in the last three fiscal years and that the Federal Government shutdown in October 2013 also contributed to the drop in audit closures for Fiscal Year 2014. Figure 2 also compares the audit coverage of all individual income tax returns to that of the high-income classes, illustrating that high-income taxpayers were more likely to be selected for audit.



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Figure 2: Percentage of High-Income Tax Return Audits by Adjusted Gross Income During Fiscal Years 2010, 2013, and 2014

Adjusted Gross Income per Individual Income Tax Return	Audit Coverage Percentage by Fiscal Year			Increase/Decrease in the Audit Coverage Percentage Between Fiscal Years 2010 and 2014
	2010	2013	2014	
\$200,000 to \$499,999	1.92%	2.06%	1.75%	-0.17%
\$500,000 to \$999,999	3.37%	3.79%	3.62%	0.25%
\$1,000,000 to \$4,999,999	6.67%	9.02%	6.21%	-0.46%
\$5,000,000 to \$9,999,999	11.55%	15.98%	10.53%	-1.02%
\$10,000,000 or more	18.38%	24.16%	16.22%	-2.16%
All Income Levels (including non-high-income taxpayers)	1.11%	0.96%	0.86%	-0.25%

Source: Table 9b from the IRS Data Books for Fiscal Years 2010, 2013, and 2014.

Appendix IV provides a more detailed illustration of the changes in the percentage of audits closed for all income levels during Fiscal Years 2010 through 2014 and also reflects that high-income taxpayers are generally audited at a higher rate than taxpayers at lower income levels.

As shown in Figure 3, the high-income audit closures as a percentage of total audits within the SB/SE Division have steadily increased. In fact, the percentage of high-income audit closures by the SB/SE Division has climbed incrementally over the last five fiscal years even while the IRS is experiencing a decline in total audit closures.

Figure 3: Percentages of SB/SE Division High-Income Examination Closures and Total Dollars Assessed During Fiscal Years 2010 Through 2014

Fiscal Year	High-Income Examination Closures	Total Examination Closures	High-Income Examination Closures as a Percentage of Total Closures	High-Income Examination Dollars Assessed (in Millions)	Total Examination Dollars Assessed (in Millions)
2010	118,462	980,674	12.1%	\$3,123	\$11,351
2011	134,278	1,005,824	13.4%	\$3,437	\$11,241
2012	138,794	983,144	14.1%	\$5,555	\$13,650
2013	135,443	920,003	14.7%	\$5,075	\$16,422
2014	130,395	823,905	15.8%	\$4,204	\$12,062

Source: Audit Information Management System closed case data.



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Figure 4 details the SB/SE Division's high-income audit closure goals for Fiscal Years 2010 through 2015.

Figure 4: SB/SE Division High-Income Examination Closure Goals

Fiscal Year	Field Examination	Campus Examination	Total High-Income Examination
2010	47,247	65,419	112,666
2011	55,224	61,286	116,510
2012	62,107	64,990	127,097
2013	63,847	65,169	129,016
2014	53,844	65,169	119,013
2015	50,305	68,681 ⁶	118,986

Source: SB/SE Division management.

The Internal Revenue Service Should Reevaluate the Income Thresholds of Its High-Income and High-Wealth Strategy

Given the IRS's goal of providing higher audit coverage to high-income taxpayers and its reduced operating budget, it is that much more important that the IRS selects audits that have the highest compliance impact. However, it is not clear that the IRS audits the most productive high-income taxpayer cases or that it has a clear rationale for the inventory balance it has established among taxpayers at different TPI levels.

We conducted an analysis on Fiscal Year 2014 audit closures of high-income taxpayers comparing the number of audits to the number of tax returns filed in Calendar Year 2013 to evaluate the IRS's audit coverage and audit productivity in the various TPI ranges. Figure 5 shows that the IRS is providing increased audit coverage as a percentage of each TPI range as the high-income taxpayers' TPIs increase.

⁶ The IRS subsequently realigned its examination coverage between the Wage and Investment and SB/SE Divisions, resulting in the SB/SE increasing its total high-income closure goal to 126,029, consisting of 49,355 for Field Examination and 76,674 for Campus Examination.



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Figure 5: Audit Coverage of Filed Individual High-Income Tax Returns Completed in Fiscal Year 2014 by TPI Level⁷

TPI Range	Tax Returns Filed in Calendar Year 2013	Audits Closed in Fiscal Year 2014	Audit Coverage
\$200,000 to \$399,999	4,111,527	62,159	1.5%
\$400,000 to \$599,999	828,622	20,245	2.4%
\$600,000 to \$799,999	334,678	10,523	3.1%
\$800,000 to \$999,999	174,408	6,470	3.7%
\$1,000,000 to \$1,999,999	284,055	14,230	5.0%
\$2,000,000 to \$4,999,999	125,758	9,117	7.2%
\$5,000,000 plus	52,078	6,309	12.1%

Source: Treasury Inspector General for Tax Administration (TIGTA) analysis of Audit Information Management System and tax return data.

Figure 6 reflects the productivity of the audits of high-income taxpayers for different TPI ranges. The highest number of audits was not conducted among the highest income taxpayers; rather, the highest number of high-income audits by far was conducted in the TPI range of \$200,000 to \$399,999.

⁷ These data do not include audits for cases in which the taxpayer had not filed a tax return.



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Figure 6: Productivity of Audits of Individual High-Income Tax Returns Completed in Fiscal Year 2014 by TPI Level

TPI Range	Count	Total Dollars Recommended	Average Dollars Recommended	Total Audit Hours	Recommended Dollars Per Audit Hour
\$200,000 to \$399,999	62,159	\$439,079,280	\$7,064	726,258	\$605
\$400,000 to \$599,999	20,245	\$192,728,249	\$9,520	244,212	\$789
\$600,000 to \$799,999	10,523	\$142,383,345	\$13,531	134,586	\$1,058
\$800,000 to \$999,999	6,470	\$116,791,097	\$18,051	87,254	\$1,339
\$1,000,000 to \$1,999,999	14,230	\$290,023,366	\$20,381	297,050	\$976
\$2,000,000 to \$4,999,999	9,117	\$314,110,939	\$34,453	181,638	\$1,729
\$5,000,000 plus	6,309	\$879,706,150	\$139,437	193,559	\$4,545

Source: TIGTA analysis of Audit Information Management System and tax return data.

The IRS's goal of providing enhanced audit coverage to high-income taxpayers is important; however, Figure 6 demonstrates that the IRS's High-Income and High-Wealth strategy devotes nearly 50 percent of its high-income audits to taxpayers earning \$200,000 to \$399,999, whose tax returns potentially present the least productivity of all high-income taxpayers. Figure 6 also reflects that the number of audits conducted by the IRS greatly declines when the income range reaches the \$400,000 TPI level. Further, the IRS audits far fewer taxpayers with incomes of \$600,000 or more even though they appear to be the most productive audits.

Over time, the IRS has adjusted the levels at which it specifically reports statistics for taxpayers with higher income. For example, the *IRS Annual Report 1989* is the first year for which the IRS reported examination coverage data specifically for individual taxpayers with TPIs greater than \$100,000. The IRS first applied examination case codes to individual tax returns with TPIs of at least \$200,000 in Fiscal Year 2005, and starting with the *IRS Databook for Fiscal Year 2007*, the IRS began reporting examination results and coverage data for individual taxpayers with TPIs greater than \$200,000.

Considering the variance in productivity shown in Figure 6 above between the lower and higher TPI ranges, we asked the IRS for the rationale behind continuing to use a \$200,000 TPI to identify high-income taxpayers. Because the IRS is devoting more audit resources for high-income taxpayers, it is important to know at what level of income or wealth taxpayers tend to begin establishing complex financial holdings that are at greater risk for noncompliance with



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the tax laws. In response, the IRS provided a July 2009 report that concluded, based on Processing Year 2006 data, that there was not sufficient evidence to support increasing the income threshold for those taxpayers it considers high-income. The IRS also stated that it has not completed any other studies pertaining to setting a TPI level for high-income taxpayers.

The decision of where to set the high-income TPI threshold has a significant bearing on how IRS audit resources are used. Because there are more taxpayers in the \$200,000 to \$399,999 range than in higher income ranges, it appears that the IRS is spending most of its audit resources on auditing tax returns with potentially lower productivity. IRS management told us that decisions on resource allocation cannot be made solely on the basis of productivity measures alone (*e.g.*, Recommended Dollars per Hour). However, given the decreasing budgets that the IRS is working under, it is critical for the IRS to determine the best use of its limited resources. While coverage of different taxpayer groups remains important, the IRS should reevaluate the appropriate income thresholds for its High-Income and High-Wealth strategy and reassess its case selection methodology to determine if more emphasis should be given to auditing taxpayers with higher TPIs to address the higher potential productivity shown for those TPI levels.

Recommendation

Recommendation 1: The Commissioner, LB&I Division, and the Commissioner, SB/SE Division, should reevaluate the appropriate income thresholds for the IRS's High-Income and High-Wealth strategy and use the results of the evaluation to ensure that audit resources are being applied to the appropriate taxpayer income levels.

Management's Response: The IRS agreed with this recommendation and will conduct an analysis of the existing income thresholds for high-income taxpayers to determine what adjustments are needed and will make the necessary adjustments.

The Large Business and International Division Is Improving Its Processes for Auditing High-Income Taxpayers

The GHW Industry initially identifies the key cases for enterprise audits by analyzing specific attributes on individual income tax returns (*e.g.*, Form 1040) of high-income taxpayers. Further analysis is done to identify related entities each taxpayer effectively controls to determine which enterprise cases are selected for audit. Since its creation, the GHW Industry has refined specific thresholds to generate the amount of audit inventory it could handle. As shown in Figure 7, the number of enterprise cases that the GHW Industry risk assessed for audit has increased annually over the past five fiscal years. Additionally, more returns are being closed each fiscal year.



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Figure 7: GHW Industry Business Results for Fiscal Years 2010 Through 2014

Fiscal Year	Enterprise Cases Risk Assessed	Enterprise Cases Outsourced	Enterprise Cases Sent to GHW Industry Examination	Number of Returns Closed ⁸	Dollars Recommended for Returns Closed (in Millions)
2010	56	0	50	12	None
2011	147	0	129	29	\$21.1
2012	184	0	157	171	\$98.2
2013	197	18	154	310	\$154.0
2014	214	12	154	359	\$234.9

Source: GHW Industry management.

Due to the complexity of most high-income taxpayers' returns, it generally takes more time than a traditional audit to build and assess the risk in each case. The case building includes researching the taxpayer's information on IRS computer systems to identify all the related tax entities that the taxpayer is involved with and compiling all the applicable return data and pertinent documents for each entity. Depending on the taxpayer, numerous related tax entities could be involved. Thereafter, the case is risk assessed to determine if an audit is warranted on the taxpayer's and his or her related entities' tax returns.

During the risk assessment process, additional internal and external research is performed to identify large, unusual, or questionable items to determine the reasons for a low effective tax rate. Risk assessors may create a flowchart of a particular return item to identify where the gain(s)/loss(es) originated (*e.g.*, from a pass-through entity). Often that requires the risk assessors to also select for audit the tax returns for the related entities with which the taxpayer is associated. When the taxpayer's enterprise is selected for audit, a research summary and supporting package is provided to the assigned examiner to help them start the audit.

In addition, LB&I Division management is actively identifying and implementing additional program enhancements. For example, they have developed a case feedback questionnaire specifically for the GHW Industry workload to obtain information from examiners in the GHW Industry and outsourced industries to help improve case selection. The feedback questionnaire includes questions to determine whether:

- The initial case data provided to the examiner were helpful and reduced the overall time spent on the audit.

⁸ Each enterprise case involves multiple returns. These are return examinations closed during the fiscal year but may not correspond to a particular enterprise case examination started in the same year.



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- The issues identified by risk assessors were appropriate and would result in an audit adjustment protecting revenue or addressed tax compliance issues.
- The examiner would have selected the return for audit considering the information provided by the risk assessment in the case file.

As of April 2015, the GHW Industry received feedback on eight enterprise cases worked by examiners in the outsourced industries. These examiners generally stated that the data provided at audit initiation were helpful and the issues identified during the GHW Industry risk assessment process were expected to result in a tax adjustment protecting revenue or address a tax compliance issue. In general, the examiners also stated that they would have selected the same returns for audit if they had conducted the risk assessment themselves. Further, several examiners provided constructive feedback on potential process improvements.

The GHW Industry Workload Selection management and staff reviewed all comments received in the questionnaire and have explored steps to address examiners' concerns. This process has led to several program improvements, such as establishing a TEFRA liaison and Account Coordinator, updating the Integrated Data Retrieval System research just prior to sending the case to the examiner, and including the Taxpayer Information Gateway report in the case research folder provided to the examiners.

In addition, the GHW Industry is generally meeting its examination return closure goals set by LB&I Division management. As shown in Figure 8, aside from the first two years, the GHW Industry has either exceeded or was close to meeting its goals each subsequent fiscal year.

Figure 8: Comparison of GHW Industry Planned and Actual Return Closures

Fiscal Year	Return Closure Goal	Number of Returns Closed ⁹
2010	55	12
2011	122	40
2012	162	205
2013	532	511
2014	360	487

Source: GHW Industry management.

⁹ The return counts in Figure 8 are higher than shown in Figure 7 because they include the Offshore Voluntary Disclosure Initiative/Program and in-process cases assigned to examiners who transferred into the GHW Industry. These cases were closed after the personnel transferred, so they counted toward the GHW Industry's productivity even though they were not associated with GHW Industry enterprise examinations.



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Cost/Benefit Analyses Were Not Performed to Support Program Decisions to Outsource Global High Wealth Industry Enterprise Case Audits

As the IRS's budget continues to decrease, the LB&I Division cannot support the full implementation of the High-Income and High-Wealth strategy for the GHW Industry enterprise audits as originally envisioned. Consequently, in September 2012, while the GHW Industry was still identified as a Compliance Initiative Project, the LB&I Division's Deputy Commissioner (Operations) directed GHW Industry management to begin outsourcing enterprise cases to other LB&I Division industries. The outsourcing initiative started in Fiscal Year 2013 with the Financial Services and the Natural Resources and Construction Industries.

While this action provided more coverage for high-income taxpayers, it also affected the ability of each receiving industry to complete its own work (Figure 9, presented subsequently in the report, shows that each industry's own work generally appears to be more productive than the GHW Industry work). As a result, examiners in these industries are replacing some of their normal case work with the GHW Industry inventory. While there is an opportunity cost for the regular work that the other LB&I Division industries are unable to undertake, the LB&I Division has not completed any fact-based performance analyses to support the benefits of its outsourcing decision. As a result, it does not know if the outsourcing effort offers the best impact on overall taxpayer compliance and revenue collection when considering the LB&I Division's inventory as a whole.

According to GHW Industry management, GHW Industry enterprise cases were used to provide productive inventory for other industries to draw from while providing greater coverage for high-income taxpayers. Specifically, GHW Industry management emphasized that the outsourcing serves two objectives by:

- Providing greater coverage for a population of taxpayers whose audit coverage rate has been historically low.
- Providing an alternative inventory that can be worked remotely (for the most part) in locations where more productive cases are currently not available.

While these objectives are valid, the outsourcing presents other challenges that would have to be considered when determining whether outsourcing is the right decision. For example:

- The complex GHW Industry enterprise cases will have to be adequately controlled to ensure that the whole enterprise is examined as planned.
- Outsourced cases are subject to the receiving industry's processes and priority discretion.
- GHW Industry management has no systemic method to monitor the progress and quality of the outsourced enterprise examinations.



Improvements Are Needed in Resource Allocation and Management Controls for Audits of High-Income Taxpayers

Although LB&I Division management acknowledged the shortcomings of the outsourcing initiative, they recently expanded this program by outsourcing 50 enterprise cases in Fiscal Year 2015. This is a significant increase as compared to the 18 and 12 outsourced enterprise cases in Fiscal Years 2013 and 2014, respectively. In addition, the LB&I Division's Communications Technology and Media Industry began working the outsourced GHW Industry inventory at this time as well.

The LB&I Division is also incurring other costs to help support and address the problems it has identified with outsourcing GHW Industry inventory. LB&I Division management stated that they have recently taken the following actions:

- Established an Outsourcing Program Manager position to provide ongoing assistance and support, including monthly calls with outsourcing teams.
- Sent a team of GHW Industry examiners, examination managers, a territory manager, and a Workload Selection group liaison to provide hands-on orientation to the teams receiving the outsourced work. Executives in the affected industries attended the orientation to emphasize the importance of working the GHW Industry enterprise case inventory.
- Provided direct mentoring support by assigning two senior examiners (General Schedule grade 14) to assist the other LB&I Division industries as subject matter experts.

GHW Industry management stated that, in addition to providing greater coverage for enterprise case audits, the outsourcing allows for higher yield cases to be worked in geographical areas where staff is currently assigned and more productive cases are not available. In addition, the outsourcing provides for a broader pool of work division-wide, when selecting the next best case to work. GHW Industry management emphasized that the success of the enterprise examinations provides strong evidence that this type of work should be part of the regular pool of work for the other LB&I Division industries.

The costs for taking these actions to improve the outsourcing process should be considered when completing a cost/benefit analysis for outsourcing the GHW Industry inventory. These actions may contribute to higher quality audit work that will meet the objectives of the High-Income and High-Wealth strategy. However, if LB&I Division management were to move audit staff directly into the GHW Industry instead of outsourcing the work, there would be improved case work accountability as well as cost savings by eliminating some redundant positions that were created to provide support to the audit staff working outsourced cases in the other industries.

The lack of an evaluation of actual program results raises some questions about LB&I Division management's decision to outsource GHW Industry enterprise cases. If productivity was the only factor in comparing results from the GHW Industry to those that work outsourced GHW inventory, the GHW Industry inventory, as shown in Figure 9, would appear to be less productive and the benefit of outsourcing may not be totally supported.



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Figure 9: Comparison of Examination Business Results Between GHW and the Outsourced Industries

Examination Productivity Yield: Dollars per Hour				
Fiscal Year	GHW Industry	Outsourced LB&I Division Industries		
		Financial Services	Natural Resources and Construction	Communications Technology and Media
2012	\$1,787	\$4,153	\$4,014	\$3,189
2013	\$1,543	\$2,868	\$6,022	\$2,860
2014	\$1,897	\$9,843	\$1,454	\$1,751

Source: LB&I Division management.

It is important to note that decisions on resource allocation should not be based solely on productivity. IRS management informed us that they must also consider other risks and audit coverage when determining which action would be most advantageous to the IRS, such as considering current prevalent issues affecting return types, income levels, and type of industry. They also emphasized that the productivity analysis in Figure 9 does not provide comparability of similar work considering the types of industries and the types of tax returns involved. However, with the productivity results being the primary metric available, LB&I Division management needs to justify the reallocation of resources to GHW inventory through a business case analysis involving a cost/benefit analysis and consideration of the other compliance risk factors.

In addition to the productivity comparisons, GHW Industry examiners have higher rates of tax return examinations closed with no adjustments (here after referred to as a “no-change”) than all of the other LB&I Division’s industries.¹⁰ Since its inception through Fiscal Year 2014, data show that the GHW Industry has closed 881 tax return examinations with approximately 41 percent of them being closed as a no-change. As Figure 10 shows, the GHW Industry’s no change rates during Fiscal Years 2010 through 2014 generally exceeded those of the other LB&I Division’s industries.

¹⁰ These rates are determined on tax returns and not the enterprise case as a whole.



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Figure 10: Comparison of LB&I Division Industries' No-Change Rates

Industry Name	Fiscal Year					Fiscal Years 2010–2014 Overall
	2010	2011	2012	2013	2014	
Global High Wealth	17%	28%	47%	43%	37%	41%
Communications, Technology, and Media	28%	16%	28%	14%	20%	20%
Financial Services	31%	31%	33%	38%	38%	33%
Heavy Manufacturing and Pharmaceutical	26%	26%	22%	24%	28%	25%
Natural Resources and Construction	27%	16%	28%	14%	21%	20%
Retailers, Food, Transportation, and Healthcare	29%	27%	27%	14%	20%	22%

Source: LB&I Division and GHW Industry management.

LB&I Division management explained that while GHW Industry examiners have higher numbers of returns closed with no adjustments, it may not necessarily translate into a high enterprise case no-change rate. It is not uncommon for related returns associated with an enterprise case to be examined from a transactional prospective to gather facts on the enterprise case as a whole. This may result in no adjustment on the related return, while the overall enterprise case examination does in fact produce additional tax assessments. An example would be an enterprise case involving a sale of property. The buyer's return could be examined to substantiate the seller's computation of the gain/loss on the transaction. While the buyer's return may not produce any changes and therefore result in a no-change, the seller's return could produce changes if the gain/loss computation was in error.

While outsourcing GHW Industry inventory may be a viable alternative for addressing the limited coverage of high-income taxpayers, there are still unknowns about whether it is the best use of the LB&I Division's compliance resources. Taking steps to evaluate the outsourcing process would help determine if the benefits justify the decision or if an alternative approach would be better. The Government Accountability Office's *Business Process Reengineering Assessment Guide* stresses that a sound business case, including a risk-based cost/benefit analysis, is the key tool for convincing stakeholders that the implemented process can achieve performance and cost-savings goals.¹¹

¹¹ GAO (formerly known as the General Accounting Office), GAO/AIMD-10.1.15 (May 1997).



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Although it is difficult to quantify the true benefits of outsourcing GHW Industry enterprise cases to the various LB&I Division industries, GHW Industry management stated that the IRS cannot put a price tag on the value of increased voluntary compliance of high-income taxpayers by working more GHW Industry enterprise cases.

It appears that the LB&I Division is at a crossroads concerning the GHW Industry and how it fits within the LB&I Division's overall compliance strategy. As the outsourcing of the GHW Industry enterprise cases has now been expanded to three industries, LB&I Division management has an opportunity to evaluate the workload of all their industries to see if the outsourcing should continue or if other staffing/resources decisions should be made.

Recommendation

Recommendation 2: The Commissioner, LB&I Division, should coordinate with the Office of Research, Analysis, and Statistics to perform a cost/benefit analysis of the outsourcing initiative to determine if its benefits outweigh the costs of the revenue foregone by the other industries. If the costs outweigh the benefits, discontinue the outsourcing initiative.

Management's Response: The IRS disagreed with this recommendation. The IRS stated that actions like those taken to use employees from a different part of the IRS can be taken without undertaking a full cost/benefit analysis. The IRS emphasized that leveraging the use of IRS employees from other LB&I industries while experiencing declining budget resources allowed it to increase its audit coverage rate for high-income taxpayers.

Office of Audit Comment: While budget constraints may have been a factor in the decision to use IRS employees from other LB&I industries to work GHW Industry enterprise cases, there is still much unknown about what was given up to enable more coverage for the GHW Industry taxpayers. With the IRS's continuing budget situation, it becomes even more imperative that a cost/benefit analysis be conducted to provide the necessary information to management in order to make and support these types of decisions.

Audit Information System Limitations Prevent Accurate Measurement of Global High Wealth Industry Performance Results

The complexity of the enterprise audit approach and limitations of the IRS's legacy audit information systems makes it difficult for GHW Industry management to systemically quantify the total tax assessments that resulted from each enterprise case examination. Audit results are posted and reported at the tax return level. Current audit information systems were designed based on the traditional single return audit approach. As a result, the available systems cannot provide an effective summary of a complex enterprise case because enterprise case audits usually involve many separate tax entities and tax returns. The only way to quantify the performance

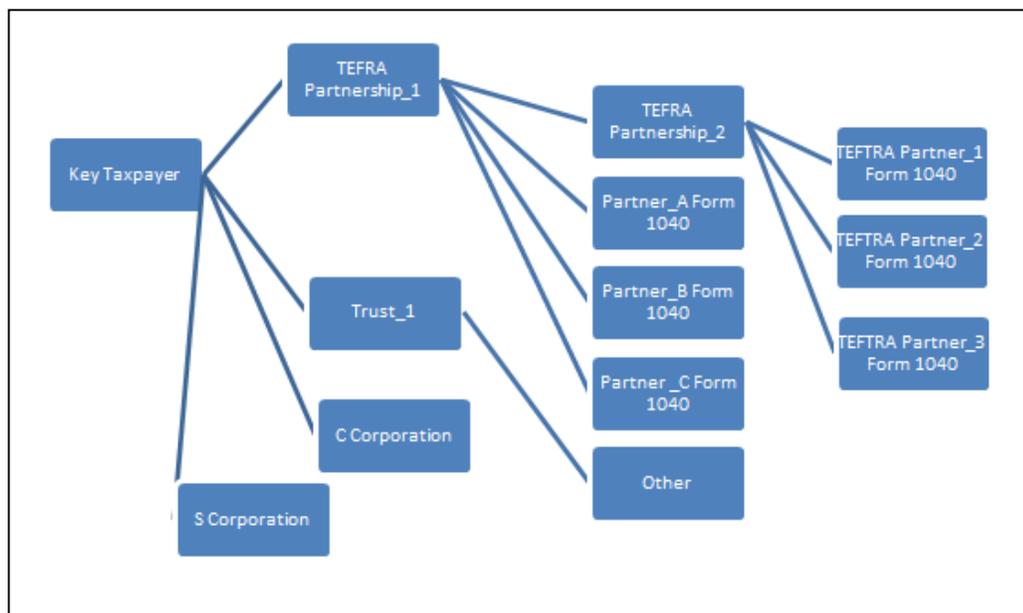


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results of the more complex enterprise cases is to manually research multiple systems and multiple related tax returns to gather the results from each audit occurring for that enterprise.

The typical IRS audit of an individual taxpayer is focused solely on his or her Form 1040 and other supporting forms and schedules. If warranted, the examiner may add the taxpayer's prior and/or subsequent year's tax returns if the same questionable issue was reported on those returns. Regardless, the examination's focus generally remains on the subject individual taxpayer. Conversely, under the GHW Industry enterprise audit approach, the examination scope of a high-income taxpayer includes the tax returns of that taxpayer, the business entities that he or she is involved with, and inevitably other taxpayers (investors and partners) who are involved with the same business enterprises. As a result, enterprise case examinations require significantly more resources due to their complexity. Figure 11 provides an example of how multiple entities can be involved as part of one individual taxpayer's enterprise.

Figure 11: Possible Tax Return Relationships in a GHW Industry Enterprise Case



Source: LB&I Division management.

Figure 11 also shows that one of the challenges of quantifying the examination results of each enterprise case is the number of tiers that may exist within a related entity (e.g., partnership), where partnerships can themselves be partners in other partnerships. The SB/SE Division's Campus TEFRA function, not the GHW Industry, is responsible for identifying and linking TEFRA partnership returns to the taxable partners, determining which partners' returns will be adjusted for the partnership adjustments, and calculating the tax impact (additional tax or refund) from the examination adjustments. The fact that many partnerships are subject to the TEFRA also compounds the difficulties in auditing enterprise cases due to specific controls the IRS puts



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on TEFRA cases. As TIGTA recently reported, the IRS's inability to quantify the tax impact of partnership adjustments has been a known problem for more than 30 years.¹² Systemic improvements are still needed to measure the success and productivity of the partnership audit process.

However, this issue goes beyond the partnership audits related to GHW Industry enterprise cases. Because enterprise cases can include other complex entities (*i.e.*, C corporations, S corporations, trusts), additional systemic improvements are needed in order for LB&I Division management to fully quantify the tax impact of GHW Industry enterprise cases.

While having numerous codes to control, monitor, and manage cases, the IRS does not have an effective way of coding related entities of an enterprise case so that performance results can be easily summarized. The GHW Industry categorizes each enterprise case as small, medium, or large based on the potential complexity of the examination. The large cases are potentially highly complex audits, whereas the small cases are considered to be simpler.

Another factor that affects the IRS's ability to report performance results for these cases is that sometimes major partnerships will execute separate agreements (Form 906, *Closing Agreement On Final Determination Covering Specific Matters*) for the entire partnership that are actually paid by the partnership and not by each partner. Similar agreements can also be executed to have the examination adjustments passed through to the individual partners, with each partner being made responsible for any additional taxes due. For these agreements, the taxes and interest will ultimately be assessed at the individual Master File account level, but the actual assessments may take months or even years to be completed.

Posting of tax assessments on minority investors can also be delayed due to open examination actions in other business operating divisions. Because the total tax assessment could be the sum of the GHW Industry enterprise case pass-through examination results and the results of the other business operating division's examination, there is no easy way to systemically distinguish between the total tax assessments from the GHW Industry enterprise case examination and any assessments from an issue isolated to a taxpayer's Form 1040.

When minority partners/investors are assessed additional taxes resulting from partnership and/or S corporation examinations, these assessments are posted separately on each minority partner/investor's individual Master File account. The key taxpayer in an enterprise examination may be the principle partner or owner of these entities. So when adjustments are made to that partnership's return, it affects the individual income tax returns for all investors. In reality, these adjustments occurred as part of the enterprise case examination. However, when the case involves the TEFRA, substantially all of the administrative responsibilities are shifted from the LB&I Division's examiners to the SB/SE Division's Campus TEFRA function. The IRS reports audit results separately for each operating division. According to GHW Industry management,

¹² TIGTA, Ref. No. 2015-30-004, *Additional Improvements Are Needed to Measure the Success and Productivity of the Partnership Audit Process* (Mar. 2015).



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performance results for the majority of TEFRA audits would be reported by the SB/SE Division even if the partnership and partners were part of a GHW Industry enterprise case. This is a significant point because, according to GHW Industry management, 65 to 75 percent of its enterprise cases involve TEFRA-related assessments.

GHW Industry management acknowledged that manual data capture and calculations are currently the only way for analyzing and computing enterprise case audit results. They also believe that reporting audit results by multiple business operating divisions is not really a major issue. However, the current process does not provide an easy method of accurately determining and documenting the results of the enterprise case audits.

To show the true success of the GHW Industry, interested stakeholders need to be provided the data necessary to fully understand the extent and the effectiveness of the enterprise audit approach. The Information and Communications standard in the *Standards for Internal Control in the Federal Government* emphasizes that program managers need both operational and financial data to determine whether they are meeting goals for accountability for effective and efficient use of resources.¹³

The original Compliance Initiative Project authorization, which resulted in the creation of the GHW Industry, established that the enterprise examination experience through Fiscal Year 2011 was to be the basis for determining what the enterprise approach was capable of producing. Thereafter, GHW Industry management was to develop new metrics (*e.g.*, use of assets to reflect the size of the taxpayer or business in computing coverage) to better reflect the impact of enterprise case results. However, to be consistent with how the LB&I Division operates, the GHW Industry has reported its performance in accordance with the LB&I Division's standard measures via the *Scorecard* reports. Even though the GHW Industry enterprise case audit methodology may be different, GHW Industry management believes that the examination process for all audits is generally similar enough to apply the standards provided in the *Scorecard* report. Consequently, opportunities may be lost by not providing detailed enterprise case examination results and identifying/profiling the nonproductive returns. This type of information not only provides important performance results to stakeholders, but can also help adjust enterprise case selection criteria and improve overall examination processes.

Recommendation

Recommendation 3: The Commissioner, LB&I Division, should coordinate with the IRS Commissioner to pursue the system modifications needed to enable GHW Industry management to systemically quantify complete enterprise case examination results and use the data to further enhance their enterprise audit approach. In the interim, the Commissioner, LB&I Division,

¹³ Government Accountability Office (formerly known as the General Accounting Office), GAO/AIMD-00-21.3.1, *Standards for Internal Control in the Federal Government* (Nov. 1999).



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should coordinate with the Office of Research, Analysis, and Statistics to develop a process to manually measure the total tax impact of GHW Industry enterprise case examinations.

Management's Response: The IRS would not commit to this recommendation at this time due to its effect on multiple business units; however, the IRS would consider system modifications as it develops an enterprise case management system, which is a Service-wide initiative.

Office of Audit Comment: The IRS is missing an important opportunity to measure the performance results of the enterprise case examination process. By delaying implementation of a system to specifically quantify enterprise case examination results, IRS management and external stakeholders will not be able to make informed decisions on the effectiveness of the GHW Industry work.

The Quality of Global High Wealth Industry Enterprise Case Audits Has Not Been Measured

The *Standards for Internal Control in the Federal Government* provide guidance to Federal agencies in creating and maintaining a strong internal control environment. Internal controls are a major part of managing an organization and are comprised of the plans, methods, and procedures used to meet an organization's missions, goals, and objectives. An effective quality review process is an internal control that provides a method for monitoring, measuring, and improving an organization's quality of work.

Aside from the first-line examination manager's case reviews completed for employee performance management, no other quality reviews are completed on GHW Industry enterprise audits on a reoccurring basis. In fact, Internal Revenue Manual 4.52.1, which governs the GHW Industry, is silent on quality reviews of enterprise case examinations. The LB&I Division's Pre-Filing and Technical Guidance – Quality and Special Projects (QSP) group is responsible for conducting quality reviews of the LB&I Division's examination program.

According to GHW Industry management, technical standards for the QSP group's use in evaluating enterprise case audits have not been formalized. Pre-Filing and Technical Guidance personnel were granted access to GHW Industry cases in March 2011 so they could become familiar with the enterprise case concept and develop specific review standards. Subsequently, Pre-Filing and Technical Guidance personnel provided suggestions on various aspects of the GHW Industry examination and administrative processes.

In July 2014, GHW Industry management provided a technical standards checklist to the QSP group with instructions that they start a special project to conduct quality reviews of closed enterprise cases examined by the GHW Industry (excluding the outsourced enterprise cases). The QSP group randomly selected 22 of 201 enterprise cases that were started by the GHW Industry after September 30, 2010, and closed before July 2014. The reviews of enterprise cases for this project started in October 2014 with a plan to report on the overall results in June 2015.



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However, the LB&I Division expedited the completion of this review. In January 2015, LB&I Division management reported an overall quality score of 81 percent for the GHW Industry project.¹⁴ The QSP group found that the GHW Industry scored 40 percent or less on four of the 38 rated quality elements. These four elements involved effective risk analyses and managerial review required during planning and examination field work. GHW Industry management stated that they are addressing the quality review findings through various training methods and future management operational reviews. GHW Industry management also stated that they have not yet determined how they will incorporate the quality review of enterprise cases and outsourced cases on a permanent regular basis.

In May 2014, the LB&I Division implemented a Process and Issue Assessment (*i.e.*, a peer review process) designed to provide a better understanding of the processes and procedures currently used in the LB&I Division's various industries to conduct their audits and develop issues unique to each industry. More specifically, the goals of the assessments are to:

1. Provide a continual process of evaluating procedures and make adjustments (as needed) based on the feedback received in the field.
2. Identify what issues are being identified in the examinations and what tools were utilized in issue identification.
3. Identify trends by industry, entity type, business life cycle, *etc.*, to improve future issue selection.
4. Identify and share best practices in collaboration and effective utilization of specialized resources.
5. Better understand taxpayers' perspectives on the examination processes and procedures.¹⁵

According to GHW Industry management, several enterprise cases will be subject to the Process and Issue Assessment during Fiscal Year 2015. While the Process and Issue Assessment is not on par with QSP quality reviews, these assessments may identify process improvements. However, the sample size is too small to provide an accurate assessment of the quality of the GHW Industry enterprise audits. The quality review functions in the IRS, including the Pre-Filing and Technical Guidance unit, use random sampling techniques to select closed cases for review. An adequate sample size is required to project the review results to the population of cases in each industry.

In addition, the LB&I Division accumulates the quality scores and reports them to its executives and management, along with other performance measures, using a *Scorecard* report. This report shows the current score for the LB&I Division's performance measures and compares each score to the target that was set for each measure. The report details the goals and actual performance

¹⁴ TIGTA did not review the accuracy of the sampling methodology and/or the basis of the results reported.

¹⁵ LB&I Division's Commissioner memorandum *Process and Issue Assessment* (May 16, 2014).



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for the LB&I Division and for each industry. However, while the LB&I Division is reporting quality scores for the GHW Industry, no QSP quality reviews were ever performed prior to the recently completed special project. For example, the Fiscal Year 2014 *Scorecard* report shows an 83 percent quality score for the GHW Industry. LB&I Division management explained that, when a specific industry's data are not measured, the practice is to report the overall LB&I Division's performance results as that industry's achievement.

The quality review of audits has always been an integral part of the IRS Examination function's internal control. The SB/SE and Wage and Investment Divisions use the National Quality Review System to select and document the sample case reviews of closed audits. The LB&I Division similarly uses its QSP reviews to monitor and measure audit quality. The uniqueness of GHW Industry's enterprise audit approach, combined with the outsourcing of GHW Industry inventory, makes it even more critical to conduct periodic QSP quality reviews of GHW Industry enterprise cases to ensure that any problems or deficiencies, such as those identified by the recent QSP quality review project, are detected in a timely manner.

Recommendations

The Commissioner, LB&I Division, should:

Recommendation 4: Ensure that the LB&I Division's *Scorecard* reports accurately reflect that there currently is no measure of GHW Industry audit quality.

Management's Response: The IRS agreed with this recommendation and will develop a plan to set targets for the GHW Industry on quality *Scorecards*.

Recommendation 5: Engage the QSP group to conduct permanent ongoing quality reviews of closed GHW Industry and outsourced enterprise examination cases and take appropriate actions based on the QSP group's findings.

Management's Response: The IRS agreed with this recommendation and GHW Industry enterprise cases worked by the GHW Industry and outsourced to other industries will be subject to the quality review process. Based on the findings from the quality reviews, the IRS will take appropriate actions.

Recommendation 6: Ensure that proper guidelines are written requiring quality reviews of closed (including outsourced) enterprise examination cases.

Management's Response: The IRS agreed that both GHW Industry enterprise cases and outsourced cases should be subject to random quality reviews; however, no additional written guidelines are required to include these cases into the quality review process.



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Appendix I

Detailed Objective, Scope, and Methodology

Our overall objective was to evaluate the IRS's efforts to ensure the tax compliance of high-income taxpayers. To accomplish our objective, we:

- I. Reviewed the documentation governing and associated with the IRS's High-Income and High-Wealth strategy, the Strategy Council, and the creation of the GHW Industry.
- II. Assessed IRS examination coverage of high-income taxpayers through IRS published statistics and obtained examination statistics directly from the business operating divisions. Specifically, we:
 - A. Compared the examination coverage in the IRS Data Books for Fiscal Years 2010, 2013, and 2014.
 - B. Obtained the total examination and the high-income examination closure statistics from the SB/SE Division.
 - C. Validated statistics provided by the business operating divisions by comparing the figures to closed Audit Information Management System data.¹ We determined that the data obtained were sufficiently reliable.
- III. Assessed the GHW Industry's programs and processes, including its effort to expand its enterprise case workload to other LB&I Division industries. We conducted a site visit to the GHW Industry office in Ogden, Utah, and accomplished the following:
 - A. Interviewed GHW Industry management and staff and obtained documentation regarding issues such as:
 - Goals and objectives of the GHW Industry and how its success is measured.
 - Impact of the IRS's and LB&I Division's organizational changes.
 - Case selection methodologies and modifications since inception.
 - Case building and risk assessment processes.
 - Outsourcing of GHW Industry enterprise cases and future plans with this initiative.
 - Quality review of the enterprise case building and risk assessment processes as well as the examination efforts.

¹ See Appendix V for a glossary of terms.



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- Outcomes from the enterprise case examinations and the business results.
- B. Obtained a copy of the GHW Industry's workload services database that tracks the enterprise cases selected, cases built, and risk assessed. We validated the data by researching 10 taxpayers' accounts via the Individual Master File and Audit Information Management System. We determined that the data obtained were sufficiently reliable.
- C. Obtained and reviewed the enterprise case inventory data for Fiscal Years 2010 through 2014, including the count of enterprise cases selected for audit. We did not perform audit tests to assess the validity of these data because the Audit Information Management System does not provide a method to track the GHW Industry's enterprise cases due to the complex structure of each enterprise.
- D. Obtained and reviewed various GHW Industry business performance reports.
- E. Requested and obtained the LB&I Division's business results for the three industries that are working the outsourced GHW Industry enterprise cases. We validated the data through analysis of examination data stored in the Audit Information Management System. We determined that the data obtained were sufficiently reliable.
- F. Requested and obtained the no-change rates for each LB&I Division industry for Fiscal Years 2010 through 2014. We validated these data through analysis of examination data stored in the Audit Information Management System. We determined that the data obtained were sufficiently reliable.
- G. Requested and obtained staffing data for each LB&I Division industry as of the end of Fiscal Year 2014. We did not perform audit tests to assess the validity of these data because the Treasury Integrated Management Information System does not provide a method to track this information by LB&I Division industry as of a specific date.
- H. Obtained and analyzed tax return and examination data for high-income taxpayers to quantify and compare audit results based on different TPI ranges.

Internal controls methodology

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined that the following internal controls were relevant to our audit objective: IRS policies, procedures, and practices for examining high-income taxpayers. We evaluated these controls by interviewing management, reviewing source materials, and analyzing taxpayer data.



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Appendix II

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Appendix III

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Director, Global High Wealth, Large Business and International Division SE:LB:GHW

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Appendix IV

Percentage of Individual Income Tax Return Audits by Adjusted Gross Income During Fiscal Years 2010 Through 2014

Adjusted Gross Income	Audit Coverage Percentage by Fiscal Year				
	2010	2011	2012	2013	2014
No Adjusted Gross Income ¹	3.19%	3.42%	2.67%	6.04%	5.26%
\$1 to \$24,999	1.18%	1.22%	1.05%	1.00%	0.93%
\$25,000 to \$49,999	0.73%	0.73%	0.70%	0.62%	0.54%
\$50,000 to \$74,999	0.78%	0.83%	0.64%	0.60%	0.53%
\$75,000 to \$99,999	0.64%	0.82%	0.64%	0.58%	0.52%
\$100,000 to \$199,999	0.71%	1.00%	0.85%	0.77%	0.65%
\$200,000 to \$499,999	1.92%	2.66%	1.96%	2.06%	1.75%
\$500,000 to \$999,999	3.37%	5.38%	3.57%	3.79%	3.62%
\$1,000,000 to \$4,999,999	6.67%	11.80%	8.90%	9.02%	6.21%
\$5,000,000 to \$9,999,999	11.55%	20.75%	17.94%	15.98%	10.53%
\$10,000,000 or More	18.38%	29.93%	27.37%	24.16%	16.22%
All Returns	1.11%	1.11%	1.03%	0.96%	0.86%

Source: IRS Data Books for Fiscal Years 2010 through 2014.

The audit coverage percentage represents the number of returns examined in that fiscal year's Adjusted Gross Income class divided by the total number of returns filed in the respective preceding calendar year for that class.

¹ See Appendix V for a glossary of terms.



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Appendix V

Glossary of Terms

Adjusted Gross Income – The total income, as defined by the Internal Revenue Code, less statutory adjustments that are primarily business, investment, and certain other deductions.

Audit Information Management System – A computer system used to control returns, input assessments/adjustments into the Master File, and provide management reports.

C Corporation – A corporation that is taxed separately from its owners. The profit of a C corporation is taxed to the corporation when earned and distributed to shareholders as dividends.

Campus – The data processing arm of the IRS. The campuses process paper and electronic submissions, correct errors, and forward data to the Computing Centers for analysis and posting to taxpayer accounts.

Campus TEFRA Function – IRS function located in the Ogden Campus in Ogden, Utah, and the Brookhaven Campus in Holtsville, New York, that provides support for field personnel when flow-through (also known as pass-through) entity audits are linked via the Partnership Control System.

Compliance Initiative Projects – Projects characterized by the use of internal or external data to identify, quantify, evaluate, and correct areas of noncompliance. They usually involve a study or other analysis of a group of individuals such as those within an industry, specific economic activity, or event.

Controlling Interest – Significant ownership of and/or influence over an entity or multiple entities within the enterprise.

Dollars Recommended – The sum of the dollars proposed to be assessed during audits of tax returns and includes all closures, including those going to Appeals or Tax Court that eventually may not be sustained during those proceedings.

Effective Tax Rate – The quotient of the total taxes paid divided by the TPI.

Fiscal Year – Any yearly accounting period, regardless of its relationship to a calendar year. The Federal Government's fiscal year begins on October 1 and ends on September 30.

General Schedule – The pay system that covers the majority of civilian white-collar Federal employees. It has 15 pay grades, from 1 (lowest) to 15 (highest). Agencies establish the grade of each job based on the level of difficulty, responsibility, and qualifications required.



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Individual Master File – The IRS database that maintains transactions or records of individual tax accounts.

Integrated Data Retrieval System – The IRS computer system capable of retrieving or updating stored information. It works in conjunction with a taxpayer's account records.

Internal Revenue Manual – The single, official source of IRS instructions to staff. It includes procedures, guidelines, policies, delegations of authority, and other such instructional materials relating to the administration and operation of the IRS.

Large Business and International Division's Industries – The business units assigned to work specific taxpayer populations generally based on the type of industry involved.

National Quality Review System – Allows national reviewers to evaluate closed audit files to determine whether examiners complied with quality attributes established by the IRS.

Processing Year – The calendar year in which the tax return or document is processed by the IRS.

Quality and Special Projects Group – This group's mission is to provide the LB&I Division with relevant data about the quality of its examination process and to promote consistency in applying quality standards throughout LB&I Division examinations. Its mission also includes identifying best practices and making recommendations for quality improvement.

Revenue Agent – Employees in the Examination function who conduct face-to-face examinations of more complex tax returns such as businesses, partnerships, corporations, and specialty taxes.

S Corporation – A corporation that elects to pass corporate income, losses, deductions, and credits through to its shareholders for Federal tax purposes.

Scorecard Report – Management information report used by LB&I Division management to monitor the achievement of performance measures and goals.

Taxpayer Information Gateway – It provides a set of case building analytical reports designed to assist LB&I Division examiners in identifying potential issues and trends.

Total Positive Income – The sum of wages, interest, dividends, and other income as well as income from Schedule C, *Profit or Loss From Business*, Schedule E, *Supplemental Income and Loss*, and Schedule F, *Profit or Loss From Farming*. When computing total positive income, only positive amounts are included; losses are treated as zero.

Treasury Integrated Management Information System – Contains payroll data for IRS employees per pay period.



Improvements Are Needed in Resource Allocation and Management Controls for Audits of High-Income Taxpayers

Appendix VI

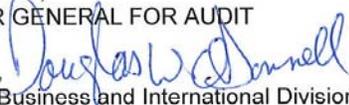
Management's Response to the Draft Report



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, DC 20224

August 31, 2015

MEMORANDUM FOR MICHAEL E. MCKENNEY,
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Douglas W. O'Donnell, 
Commissioner, Large Business and International Division

SUBJECT: Draft Audit Report # 2014-30-023 - Improvements Are Needed in Resource Allocation and Management Controls for Audits of High-Income Taxpayers

Thank you for the opportunity to review and comment on the subject draft report. High-income taxpayers can present a unique challenge to tax administration due to the complexity of their financial affairs. As noted in your report, high-income taxpayers are frequently involved in complex financial holdings or off-shore activities, which present a greater risk of non-compliance with the tax laws. To address this, the IRS adopted (in 2009) a High-Income and High Wealth (HIHW) strategy focused on addressing noncompliance and improving voluntary compliance by this population of taxpayers. As part of this strategy, we established the Global High Wealth (GHW) Industry, which takes a comprehensive approach in auditing high-income taxpayers by extending the audits beyond the individual income tax return to include examining the entities that these taxpayers control. These initiatives have resulted in increased audit coverage of high-income taxpayers; while at the same time, there have been many developments and initiatives aimed at addressing non-compliance with respect to off-shore accounts and assets (for example, FATCA and the IRS' offshore voluntary disclosure program).

Your report recommended that we re-evaluate the income thresholds that are used in our HIHW strategy, to ensure that we are selecting the most productive cases. We agree that a reevaluation and a periodic indexing of this threshold would be advisable, especially in light of our declining budget resources. However, as noted during the course of the audit, our decisions on resource allocation cannot be made solely on the basis of productivity measures (i.e., "yield"). As reflected in the IRS' recent future state visioning, the keystone of our compliance activities is to promote voluntary compliance, by identifying and working issues that have an impact on changing taxpayer behavior, and also providing a deterrent to other potentially noncompliant taxpayers.

We appreciate your recommendations, as we are always seeking ways to improve our programs. Attached is a detailed response outlining the corrective actions the IRS will take to address your recommendations. If you have any questions please contact me, or members of your staff may contact Cheryl Claybough, Acting Director, Global High Wealth Industry at (510) 637-4615 or (202) 615-7602.

Attachment



Improvements Are Needed in Resource Allocation and Management Controls for Audits of High-Income Taxpayers

2

Attachment

RECOMMENDATION 1:

The Commissioner, LB&I Division, and the Commissioner, SB/SE Division, should reevaluate the appropriate income thresholds for the IRS's High-Income and High-Wealth strategy and use the results of the evaluation to ensure that audit resources are being applied to the appropriate taxpayer income levels.

CORRECTIVE ACTIONS:

The IRS will conduct an analysis of the existing income thresholds for HIHW returns to determine what adjustments are needed, and will make the necessary adjustments.

IMPLEMENTATION DATE:

October 15, 2016

RESPONSIBLE OFFICIAL(S):

Commissioner LB&I and SB/SE Director, Examination Operations

CORRECTIVE ACTION(S) MONITORING PLAN:

The IRS will monitor this corrective action as part of our internal management system of controls.

RECOMMENDATION 2:

The Commissioner, LB&I Division, should coordinate with the Office of Research, Analysis, and Statistics to perform a cost/benefit analysis of the outsourcing initiative to determine if its benefits outweigh the costs of the revenue foregone by the other industries. If the costs outweigh the benefits, discontinue the outsourcing initiative.

CORRECTIVE ACTIONS:

We do not agree with this recommendation. While the benefits and limitations of a cost-benefit analysis are not in dispute, some actions can be taken without undertaking a full cost-benefit analysis, as recommended above. Also, utilizing employees from a different part of IRS does not constitute an "outsourcing initiative". In light of our declining budget resources, leveraging the use of IRS employees from industries outside of the GHW Industry allowed us to increase our audit coverage rate for the segment of taxpayers covered by the GHW Industry.



Improvements Are Needed in Resource Allocation and Management Controls for Audits of High-Income Taxpayers

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IMPLEMENTATION DATE:

N/A

RESPONSIBLE OFFICIAL(S):

N/A

CORRECTIVE ACTION(S) MONITORING PLAN:

N/A

RECOMMENDATION 3:

The Commissioner, LB&I Division, should coordinate with the Commissioner, IRS, to pursue the system modifications needed to enable GHW Industry management to systemically quantify the complete enterprise case examination results and use the data to further enhance their enterprise audit approach. In the interim, the Commissioner, LB&I Division, should coordinate with the Office of Research, Analysis, and Statistics to develop a process to manually measure the total tax impact of GHW Industry enterprise case examinations.

CORRECTIVE ACTIONS:

This recommendation affects multiple Business Operating Divisions (BODs), and as such has Service-wide implications. This initiative would be an IRS-wide undertaking to modify existing systems and would have significant funding requirements. We cannot commit to this recommendation at this time; however, we will consider it as we develop our Enterprise Case Management system, which is a Service-wide initiative.

IMPLEMENTATION DATE:

N/A

RESPONSIBLE OFFICIAL(S):

N/A

CORRECTIVE ACTION(S) MONITORING PLAN:

N/A

RECOMMENDATION 4:



Improvements Are Needed in Resource Allocation and Management Controls for Audits of High-Income Taxpayers

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Ensure that the LB&I Division's *Scorecard* reports accurately reflect that there currently is no measure of GHW Industry audit quality.

CORRECTIVE ACTIONS:

While LB&I will not restate previous scorecards, LB&I GHW will work with PAIR going forward to develop a plan to set targets for the Industry on quality scorecards. While GHW currently does not have a target, we do have a score and QSP has just recently performed quality reviews for GHW as mentioned in the report which will be used to begin development of targets. In addition, GHW is conducting PIA reviews on other industry cases, as well as GHW having cases being selected for PIA reviews this cycle. Going forward, GHW enterprise cases will be subject to quality review.

IMPLEMENTATION DATE:

October 1, 2016

RESPONSIBLE OFFICIAL(S):

Director GHW and Director PAIR

CORRECTIVE ACTION(S) MONITORING PLAN:

The IRS will monitor this corrective action as part of our internal management system of controls.

RECOMMENDATION 5:

Engage the QSP group to conduct permanent ongoing quality reviews of closed GHW Industry and outsourced enterprise examination cases and take appropriate actions based on the QSP group's findings.

CORRECTIVE ACTIONS:

LB&I agrees that GHW enterprise cases will be subject to the QSP quality reviews. These cases will be part of the total sample size for LB&I at large as well as the outsourced cases subject to random selection for QSP audit. Based on QSP's findings, appropriate actions will be implemented.

IMPLEMENTATION DATE:

Oct. 1, 2016



Improvements Are Needed in Resource Allocation and Management Controls for Audits of High-Income Taxpayers

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RESPONSIBLE OFFICIAL(S):

Director GHW and Director PFTG

CORRECTIVE ACTION(S) MONITORING PLAN:

The IRS will monitor this corrective action as part of our internal management system of controls.

RECOMMENDATION 6:

Ensure that proper guidelines are written requiring quality reviews of closed (including outsourced) enterprise examinations cases.

CORRECTIVE ACTIONS:

LB&I agrees that both GHW enterprise cases and outsourcing cases should be subject to the random QSP quality reviews. No additional written guidelines are required to include these cases into these random samples.

IMPLEMENTATION DATE: Implementation should take place immediately to include these cases into the population of random sampling for review.

Oct. 1, 2016

RESPONSIBLE OFFICIAL(S):

Director GHW and Director PFTG

CORRECTIVE ACTION(S) MONITORING PLAN:

The IRS will monitor this corrective action as part of our internal management system of controls.